A Review of Creative Accounting Practices and Its Area, Technique and Ways of Prevention

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Abstract: Creative accounting has become very interesting topic recently. This is due to the increase of scandal that involves large companies worldwide. Despite the wide spread of creative accounting practices, the academic studies are still few. The areas, techniques, reasons, and prevention of creative accounting practices were varied. The purpose of this study is to review and integrate the literature to investigate the creative accounting practices and its area, techniques, reasons, and method of prevention. A total of 22 articles were reviewed and analyzed. The findings indicate that financial statements are the most violated and manipulated area by creative accounting practices. The most prevalent technique is the manipulation of information to the stakeholders and shareholders. In addition, the findings reveal that reason of creative accounting differ between private and public companies. Private companies use it to hide its income and reduce tax. While public companies use it to boost the price of shares. Ways of prevention found to be by implementing strict accounting measures or establishing ethical and behavioral commitment of professional accountant. Findings were discussed and direction for future work was given.

Keywords: Creative Accounting Practices, Area, Techniques, Reasons, Prevention

1. Introduction

Creative accounting practices has been one of the most important topics since the collapse of major companies in the United States (U.S) such as Enron, World.Com, and Arthur Anderson. These companies differ in their cores and operations but they share the same reasons for their collapse which is the creative accounting practices. Since the beginning of last decades, governments and accounting bodies have enacted many laws and legislations to prevent the creative accounting practices. One of the laws is the Sarbanes-Oxley Act in U.S and similar laws were enacted in other countries [1].

Creative accounting was defined by [2] as the deliberate distortion of the communication between entities and shareholders by the activities of financial statement preparers who wish to change the content of the message being transmitted. Thus, creative accounting does not violate the law or the standards of accounting. It is mainly based on finding loopholes in accounting rules that enable the professional accountant to alter the financial income of companies.

Professional accountant are the persons that are responsible for preparing the financial statements of the companies and they are the ones who certify these report to be true and fair. Generally, the professional accountant adheres to specific code that guides them in preparing the financial statements. The creative accounting occurs when the professional accounting find a loopholes in the accounting standards and code of conduct this is because the degree of adhering to these codes is varied based on individual, organizational, culture, and traditions perceptive [3].

Previous studies related the creative accounting practices to many reasons including the boost of share prices, taxes, and dividends [4], [5], [6]. Similarly, the area and techniques that have been used differed between financial statement, balance sheets, accounting policies and inventory system [7];[8]. For preventing the creative accounting, researchers have not come to agreement on the ways that can prevent the creative accounting practices. While some researchers argued that by applying the accounting standard and preventive measures [9] other suggested the establishment of ethical commitment and ethical behavior [10].

The problem is that despite all the measures that have been taken by governments to prevent the creative accounting, there is increasingly scandal related to creative accounting practice in almost every day around the world. There is need to identify the reasons behind the creative accounting practices, and in what area they occur more often. In addition, there is need to identify the techniques that are used and more importantly, the ways that can prevent the conduct of creative accounting practices. Thus, this paper review and integrates the literature to come up with the reasons, area, techniques, and prevention of creative accounting practices. The paper consists of five sections. First section presented the background of the paper and highlighted the issues and objectives. Second section provides a review of the literature. Third section describes the research methodology. Fourth section discusses the findings of this study. Lastly, the fifth section concludes the study and provides the direction for future works.

2. Literature Review

2.1 Creative Accounting

The concept of creative accounting is usually used to describe the process through which the accounting professionals use their knowledge in order to manipulate the figures included in the annual accounts. Many names can be associated with creative accounting such as earning management. While in Europe, the term is known as creative accounting income smoothing, earnings smoothing, and cosmetic accounting, and financial engineering [10]. Creative accounting is defined as “a process of manipulating accounting to take advantages of the loopholes in accounting
rules and the choices of measurement and disclosure practices” [12]. According to [11] creative accounting is a process which the accountants use their knowledge of the provisions and accounting rules to manipulate the financial statements. Moreover, creative accounting was described by [2] as an intention distortion of the communication between management and shareholders in term of the financial statement preparers who like to adjust the real fact about the company. It was described as one of the practices that some companies use to gain benefits in short or long term [10].

2.2 Areas and Techniques

Previous studies in creative accounting have identified many areas and techniques of creative accounting. In a study conducted by [2] to identify the creative accounting and its nature along with incidence and ethical issues, they pointed out that the creative accounting techniques that might occur include issues such as regulatory flexibility, dearth of regulation, management interest, time of conducting some big transactions, presenting encouraging financial statement. Differently, [13] pointed out that there are useful techniques of creative accounting.

Akenbor and Ibanichuka [4] found that the main goal of practicing creative accounting is to boost the value of the shares in the stock market and to mislead the shareholders. Moldovan, Achim and Bota-Avram [14] reviewed many opinion and perspectives about the fraud cases and the professional ethics with creative accounting and recommended that the solution for creative accounting is the ethics and adhering to accounting rules and professional accounting ethics. However, these recommendations were criticized and they were to be tested practically.

Sanusi et al [15] provide a description of the areas of creative accounting to include financial statements, namely revenue, and assets and amortization policies. Yadav [6] pointed out that the areas include tangible assets, goodwill, depreciation, inventories, provisions for liabilities and charges, and construction contracts. Agarwal [16] has identified many other areas that include off- balance sheet financing, inventory system, modifying depreciation policies, leasing, increase income, manipulating expenses, acquiring goodwill.

In similar approach, [7] pointed out that the creative accounting practices can occur in the areas of accounting policies, changes in accounting policy, overvalue closing stock, provisions for bad debts, legal obligations, and the current profits.

It can be seen that any alteration to the true and fair of the financial statement could be considered as a creative accounting practices and this includes almost all the area of information that exposes to the public. In term of techniques, it could be misleading information for the stakeholders.

2.3 Reasons of Creative Accounting

The big question is why companies conduct creative accounting practices? One of the reasons is to hide something that they do not wish the stakeholder to see or to be aware of. For public listed companies, the main reason is to boost the prices of the shares in the stock market [4]. Other reasons include the desire to avoid paying tax as creative accounting can enlarge the expense and reduce the amount of taxes that the company has to pay to the government [17]. This is because the taxes are calculated based on the net income of the company. Thus, companies would try to minimize their income to reduce the amount of money that they have to pay as tax of income. For [5] the creative accounting practices were increased due to many reasons that include the payment of dividends, the choice of accounting method, the category of extraordinary item in the profit and loss account, the quality of earnings report of the income statement by external auditors, the ethical of accountants, and lastly the weaknesses of the control system.

Agarwal [16] found that companies involve in creative accounting practices due to reasons such as debt structure of the companies, the financial distress, the increasingly competitive environment, practices of internal control mechanism, the ownership structure of the company, and the interest of the chief executive officers (CEO) to increase the profits figures thus his payments and rewards will increase accordingly.

Yadav [6] related the creative accounting practices to the loopholes that are existed in the accounting standards and regulations. Shah et al. [13] related the creative accounting practices to the desire to meet the organizational targets and goals, meet the external expectation of the company performance, provide income smoothing, window dressing for initial public offering or a loan, tax reduction, and changes in the management structures.

2.4 Prevention of Creative Accounting

There is no agreement between researchers regarding the ways of preventing the creative accounting practices. Fišerová [18] pointed out that by enforcing the standards of accounting, the creative accounting practices will reduce. Similarly, the [19] determine the creative accounting can be detected by internal audit. Ghosh [20] suggested the implementation efficient auditing, strong regulation, reduction of the choices of accounting treatment in accounting standards, and improving the quality of corporate governance.

The other group of researchers tended to suggest solutions related to the ethical commitment and the ethical behavior of professional accountants. Al Momani [10] pointed out that the prevention of creative accounting could be achieved by establishing ethical commitment and ethical behavior of the professional accountant who are in charge of preparing the financial statement and the income statement. Abiodun [9] explored the best way to prevent the creative accounting in real work is to apply preventive measures, since the general accepted accounting principle create a gap that authorize the practices of creative accounting. Al Momani and Obeidat [10] pointed out that the auditors’ independency, integrity, and objectivity affects the auditors’ ability to detect the practices of creative accounting. However, the auditors’ ability to detect the practices of the creative accounting is affected by the entire group of audit ethics more than their independency, integrity, and objectivity. Rahman [8] merged between the two groups and suggested solutions that include
strict measures as well as the implementation of ethical commitment. They suggested more rigorous accounting standard, awareness of audit committee, corporate governance and consciousness.

3. Methodology

This study is a literature review study. The study reviewed the available articles related to the creative accounting practices. Google search engine was used to search for articles. Key words such as creative accounting, practices, techniques, reason of creative accounting practices, area of creative accounting practices and a combination of these words were used to find the related articles. A total of 22 articles were found and they were reviewed and analyzed. The article time period ranges from 2002 to 2015. The findings of other researchers were analyzed to present the findings of the present study.

4. Findings

It can be seen that despite the strict laws and the punishment of creative accounting that implemented by governments, the creative accounting practices are still exist. This shows clearly that professional accountant still have the ability to find loopholes in the existed standards and are able to violate and manipulates these standards. The study has indentified many areas of creative accounting practices that include financial statements, accounting policies, tangible assets, depreciation, and inventory. Nevertheless, the most important area is the financial statement of the company as it was identified by the majority of researchers as the most violated area by creative accounting practices [14]; [8].

In term of the techniques, the study found that most of the companies have used the manipulation of financial reports as the most used techniques to mislead the stakeholders this includes the profit and loss and modification of depreciation policies, provision of bad debts. Table 1 shows the area and techniques of creative accounting practices.

<table>
<thead>
<tr>
<th>Author/Year</th>
<th>Area</th>
<th>Techniques</th>
</tr>
</thead>
<tbody>
<tr>
<td>[14]</td>
<td>Financial reports</td>
<td>Manipulate the financial reports</td>
</tr>
<tr>
<td>[15]</td>
<td>Financial Statements, revenue, and assets and amortization policies</td>
<td>Distortion of information</td>
</tr>
<tr>
<td>[6]</td>
<td>Tangible assets, goodwill, depreciation, inventories</td>
<td>Provisions for liabilities and charges, and construction contracts</td>
</tr>
<tr>
<td>[16]</td>
<td>Off-balance sheet financing, inventory system,</td>
<td>Modifying depreciation policies, leasing, increase income, manipulating expenses, acquiring goodwill</td>
</tr>
<tr>
<td>[22]</td>
<td>income management, manipulation of expenses</td>
<td>Deferring costs, reserve accounting, capitalization of expenses, overvaluing assets, concealment of losses or liabilities, tampering taxation, off-balance-sheet financing, inventory.</td>
</tr>
<tr>
<td>[8]</td>
<td>Accounting statement</td>
<td>Cookie jar reserve, the investment portfolio, a problem child, and introduction of new standards</td>
</tr>
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</table>

For the reason of creative accounting practices it differs based on the nature of the company. It was found that if the company is public listed, the ultimate goals is to boost the price of share in the stock market. Nevertheless, if the company is private company, the ultimate goal is to reduce the amount of tax payable to the government or to reduce the dividends that the company pays for the shareholders. For both the public and private companies, the reason behind creative accounting practices could be the need to obtain loan from banks. Table 2 shows a summary of the reasons of creative accounting practices for both public and private companies.

<table>
<thead>
<tr>
<th>Author/years</th>
<th>Reason</th>
<th>Type of company</th>
</tr>
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<tbody>
<tr>
<td>[4]</td>
<td>Boost share price in the stock market</td>
<td>Public company</td>
</tr>
<tr>
<td>[17]</td>
<td>To avoid paying tax</td>
<td>Public and private</td>
</tr>
<tr>
<td>[5]</td>
<td>payment of dividends</td>
<td>Public and private</td>
</tr>
<tr>
<td>[16]</td>
<td>debt structure, financial distress</td>
<td>Public and private</td>
</tr>
<tr>
<td>[21]</td>
<td>encourage investors to buy the companies’ share</td>
<td>Public company</td>
</tr>
</tbody>
</table>

Researchers have divided into two opinions regarding the methods of preventing creative accounting practices. The first opinion is to enforce the standards of accounting and implement strict measures to make professional accountant aware of the consequence of violating or manipulating the financial statement. The second opinion is to establish the ethical commitment and the ethical behavior. It was argued by researchers that the ethical behavior of the professional accounting could prevent them from conducting creative accounting practices. This is supported by the fact that despite the strict measures, the creative accountings practices are still exist. Thus, it is believed that the ethical commitment of the professional accountant is more important that implementing strict measures to prevent the creative accounting practices. Table 3 shows the methods of preventing creative accounting practices.
Table 2: Prevention of Creative Accounting Practices

<table>
<thead>
<tr>
<th>Authors</th>
<th>Prevention</th>
</tr>
</thead>
<tbody>
<tr>
<td>[18]</td>
<td>Applying accounting standards</td>
</tr>
<tr>
<td>[19]</td>
<td>Strict internal audit</td>
</tr>
<tr>
<td>[17]</td>
<td>establishment of ethical commitment and to the ethical behavior of the professional accountant</td>
</tr>
<tr>
<td>[10]</td>
<td>Auditors’ independency, integrity and objectivity</td>
</tr>
<tr>
<td>[20]</td>
<td>Action by the responsible bodies and agencies efficient of audit, strong regulation, modify company act,</td>
</tr>
<tr>
<td>[9]</td>
<td>apply preventive measures</td>
</tr>
<tr>
<td>[8]</td>
<td>Strict measures as well as the implementation of ethical commitment</td>
</tr>
</tbody>
</table>

5. Conclusion and Future Work

The purpose of this study was to investigate the creative accounting practices and their area, techniques, reason to conduct creative accounting practices, and the methods to prevent the creative accounting practices. The findings of the study showed that among the creative accounting area, financial statement was the most violated area. In term of techniques, manipulating the information that are exposed to stakeholder was the most prevalent techniques that used by professional accountants.

The reasons behind the creative accounting practices differ based on the type of the companies. Public listed companies aimed to boost the price of their shares in the stock market while private one aimed to hide their income to reduce the tax that are payable to the government. Both of them wanted to enhance the financial situation of the company to be able to obtain loan from banks.

The solution of creative accounting practices could be divided into two. The first is to enforce the accounting standards and apply strict measures and punishment on those who violate and manipulate the financial statement. The second is to establish ethical commitment and ethical behavior of the professional accountant.

For future work, it was found that the empirical studies related to the creative accounting practices are few especially in developing countries. Therefore, it is recommended to conduct a study using a questionnaire to ask professional accountant about their opinion regarding the creative accounting practices and the degree to which the ethical commitment could affect the creative accounting practices. Another direction for future work is to conduct an empirical study to compare the effects of both ethical commitment and the enforcement of strict measures and applying accounting standards on the prevention of creative accounting practices.

References

